LIGHTING UP YOUR COSTS TO IMPROVE YOUR PROFIT

by Steve Brown

Last summer we moved our company from the financial district of San Francisco across the bay to one of its suburbs. We saved 30% on rent by moving 18 miles, but the move also means some must now navigate the Bay Bridge daily. Like anything on the daily commute, after a certain point one pays less attention to the details good or bad. This bridge that passes vehicles from Oakland to San Francisco isn't as pretty as the Golden Gate, but perhaps that is about to change. A new bridge is nearly completed and art has been installed that will offer an LED light sculpture that will illuminate the 1.8 mile span with 25,000 lights. One has to wonder whether the original designers of these bridges more than 75Ys ago would have conceived of their importance in the movement of traffic. The Bay Bridge carries more than 100mm cars annually and the Golden Gate carries around 40mm. As with an infrastructure like a bridge, long-term planning for your bank is similar. If you had asked your management team 10Ys ago for a likely range of your net interest margin (NIM), the yield the loan portfolio would be generating and the bank's likely cost of funds, do you think the estimates would be anywhere close to today? We doubt it and would venture to say most would likely have been much higher. Then and now, most banks focus on trying to generate more return on the asset side of the balance sheet and back into the funding side. In today's environment, however, it has been very difficult to grow loans and investment yields are also very low. To boost margin, banks need to focus on deposits. Sure they have are low in historical terms, but much more can actually be done so it is worth a look. Consider the FDIC national average deposit pricing curve is still trending downward, so some banks continue to actively manage their cost of funds lower. For banks to simply remain in the same ranking, the cost of funds must be reduced by around 3bp to 6bo each quarter. To improve, the reduction must be even greater. If you still aren't sure, consider the latest FDIC data showing the quarterly cost of funds for banks under $1B as of Dec. 2012 was 68bp, while it was only 46bp for those banks above $1B in assets. This difference of 22bp may not sound like very much, but on a percentage basis it is about 48%, so there is plenty of room to improve. It also shows deposit costs can still be reduced even further than they are given this competitive positioning. It is also important to remember that deposit costs are one area you can still take more control. Typically customers are less rate- sensitive (particularly right now) when it comes to what they earn on deposits than what they expect to pay on their loans. As a result, reducing deposit costs is a way banks can improve earnings with generally little customer backlash. To improve in this area you have to focus continually, as you measure, monitor and take action over time. Adjusting rate, product mix and ensuring behavioral changes occur in the bank are all needed to successfully reach your goals. If you need help or you doubt you can cut funding costs much more than they already are, call us to take the challenge. Ask for a demonstration of our Liability Coach product, to see what lights we can turn on in your deposit base to help illuminate how to generate income despite these tough times.

Related Links:

PCBB 2013 Executive Management Conference

BANK NEWS

Compensation

Reuters is reporting that the Fed wants banks to pay executives based solely on the profitability and performance on the bank and not how the company compares to peers. The thought is that plans based on performance to peers can encourage executives to take more risk to keep up with stronger or better capitalized competitors. This also means many bank compensation consultants we know operating in the community bank space will now have to go back to the drawing boards and change the way they do things.

Pension Fraud

The former CEO and a board member of The California Public Employees' Retirement System (CalPERS) have been indicted for fraud, after an investigation into influence peddling and corruption. The two reportedly created fake investor disclosure letters and then paid a firm run by the board member some $14mm in fees. Both left in 2008. CalPERS manages pension and health benefits for 1.6mm CA public employees and retirees and as of 2008 managed the largest pension fund in the US at $179B.

Investment Analysis

Effective at the beginning of this year, every bank can no longer rely on credit ratings when determining whether an investment security is permissible to purchase. Banks must make sure all issuers have adequate capacity to meet financial commitments under the security for the projected life of the asset. Banks can still use external ratings as a portion of the analysis, but a full assessment of issuer capacity to repay is now required.

Home Inventory

It is interesting to note that surging investor appetite has removed an estimated 5mm homes for sale from the market so far in 2013, compared to the end of 2007.

Less Insurance

Research by Thomson SDC finds the percentage of new municipal issuance volume with insurance has fallen from 60% in 2005 to only 2.7% as of Feb. 2013.

Municipal Mix

So far this year, JPMorgan research finds municipal bond issuance (based on percentage of total issuance) has occurred in: general purpose/public improvement (25.2%); primary/secondary education (22.0%); higher education (10.3%); water/sewer (9.6%) and general acute care hospital (4.4%).